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Strong, Benjamin

An address ... before the Merchants' Assoc. of N.Y.

[Philadelphia]

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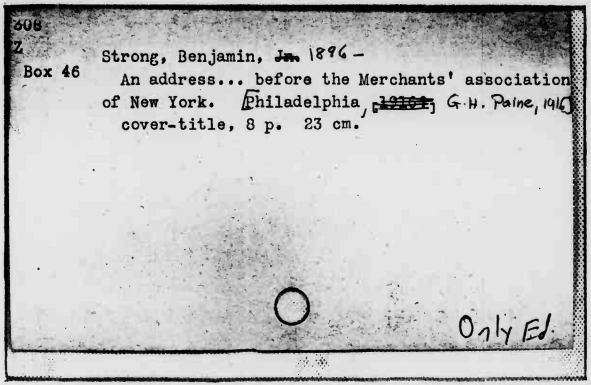

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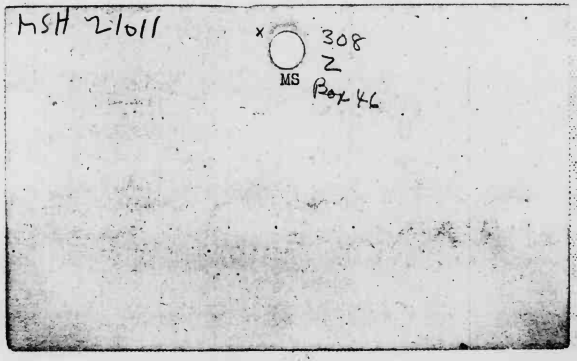
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AN ADDRESS

By

Mr. BENJAMIN STRONG, Jr.

Governor of the Federal Reserve Bank of New York

Before The Merchants' Association of New York

308
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Box 46

Sent out with the Compliments of George H. Paine, Philadelphia, Pa.

Mr. Strong's Speech

This in indeed a prosperity luncheon. I sympathize with your desire to permit the Federal Reserve Bank to contribute to the object of the meeting. I should also warn you that the Reserve Banks cannot make prosperity. As they gradually assume their functions they will certainly aid in the recovery of business from the shock of war and I hope will reap their share of the rewards.

A Powerful Force.

Until November 16th the Federal Reserve Act was simply the expression of what Congress believed the country demanded in banking and currency legislation. Since November 16th it has become a powerful force behind our business machinery. The test of its ability to accomplish the objects desired will be determined by the experience of the future. We must bear in mind that banking legislation in the United States affects over 25,000 institutions with resources of $25,000,000,000. Since the panic of 1907, the States of New York, Pennsylvania, Ohio, Illinois and California have made important or complete revisions of State banking laws, and Congress has enacted the Federal Reserve Law. Legislation of this sweeping character, which in the case of the Federal Act reposes broad powers of interpretation and direction in a Federal Board, must be dealt with conservatively. The defects of the old system may have been corrected by the new, but we must be sure that other defects have not crept undetected into the act from which unsound tendencies may develop, thereby defeating the purpose of Congress and creating other weaknesses which it would require further legislation to correct. Judgment must be suspended and a generous attitude must be observed both toward the Federal Reserve Board and the measures adopted by it for the development and control of the new system and toward the managements of the various Reserve banks in their exercise of the functions of these new institutions. A liberal spirit of co-operation will insure the success of the system. Determined opposition can be made to defeat its progress.

Spirit of Co-operation.

The first notable development in the inauguration of the system was the payment of the capital installment, and during the past

week, the completion of the initial reserve transfer, largely in gold, without recourse to the deposited reserves in the reserve and central reserve cities. Out of $110,000,000 of such transfers made to the Federal Reserve Bank of this City, a negligible amount was made by New York banks for account of their correspondents in this district, and over $85,000,000 of the amount transferred was in gold. The spirit of co-operation thus exhibited by the banks of this district and particularly by the members of the New York Clearing House Association in this as in all matters connected with the establishment of the Federal Reserve Bank of New York, gives striking evidence of their intention to permit no opposition to develop which may interfere with a thorough test of the plan. This insures its success.

Loyalty of the Bankers.

I take this oportunity to express my admiration of this body of men, our New York bankers, who again give evidence of their loyalty to American Institutions in true American spirit. The co-operation of the National banks, so necessary to the future of this great plan, has been amply assured. Of that the evidence is abundant. Similar co-operation by State institutions is of almost equal importance, and that of the business men of the country is essential. Plans for the admission of State institutions to membership in the system will, I believe, develop rapidly and afford means for enlarging the scope and usefulness of the system, without placing burdensome restrictions upon the State institutions or subjecting the National banks to unreasonable competition. The soundest banking system possible for this country should embrace in its operation all banks which receive demand deposits and discount commercial paper. Congress has now provided for the establishment of an entirely new class of banks.

An Elastic Currency.

Their most important functions will be to provide an elastic currency, to afford means of rediscounting commercial paper by the members of the system, to act as the depositaries and fiscal agents of the Government, to effect the gradual retirement of our bond-secured National bank notes and to furnish the machinery for the clearance of checks and a more economical adjustment of domestic

exchanges. In addressing you, however, I shall refer to only one section of the law in which you have a special interest from the standpoint of the mercantile borrower. Some of you, no doubt, have at times been subjected to the uncertainty and anxiety of having obligations to meet without the immediate means of meeting them, except through credit with a bank. Your business may have been in a sound condition, but still your bank be unable to care for your legitimate needs. Certainly your business, as well as your peace of mind will be promoted by a greater certainty in regard to your credit at the bank, and particularly at a time when money rates may be high and business uncertainty prevail.

Will Broaden Loan Market.

Therein lies an important function of the Reserve Bank System. It will broaden and stabilize the market for commercial borrowings. The Federal Reserve Act provides for the discount by Federal Reserve Banks (I quote from the law) "of notes, drafts and bills of exchange arising out of actual commercial transactions." The limitation thus imposed upon the Reserve banks in the character of paper which they may discount raises three important questions: First, shall the test of the eligible character of the paper be evidenced in the form of the paper itself? Second, if the note does not bear such evidence on its face shall the Federal Reserve banks accept the statement of the member banks that it does comply with the statute, or Third, shall the member banks provide themselves with such means of information as will enable them to determine whether paper offered for discount complies with the statute?

Commercial Paper.

The note of a merchant representing goods purchased, if drawn upon an acceptor who may be either the purchaser of the goods or a bank or banker, affords reasonably certain evidence on its face of the character of the transaction which it represents, and that it complies with the statute. Such paper is, in fact, the bill common to the London market, and known by bankers the world over. If gradually, without undue disturbance of existing methods, the accepted bill can be substiuted for the note of hand, a class of paper will be created which will command a premium in the money

markets of this country. Its convertibility at minimum rates of discount will serve as an inducement to both the buyer and the seller of goods to substitute this form of credit for direct bank borrowings against book accounts. Many obstacles must be overcome before any such practice can be generally introduced. A merchant drawing a bill in Hongkong for acceptance in New York must know that the bill can be sold in Hongkong. The bank in Hongkong with which he does business and which will be asked to buy the bill, must know that the credit is good, and if it buys the bill that he or his agent (say in New York) can get immediate discount. He should be able to ascertain the rate, and should know that the rate will be fairly stable. While the banker in Hongkong will know the drawer of the bill, he must also be informed as to the standing of the acceptor in New York. There are to-day in this country no acceptance houses, very few of the National and State banks are engaging in the acceptance business, and furthermore, unfortunately, the Federal Reserve Act limits the new acceptance privilege of the National banks to the acceptance of bills representing the exportation or importation of goods.

Credit Information.

In England the small number of acceptance and discount houses, which, however, do a vast volume of business, has enabled the business and banking world to become familiar with London credits to an extent that is not true of any other money center. Similar information regarding our credits must be disseminated the world over. Knowledge of the credit of American firms and institutions will follow the trade of the country, but it will not precede it. The process of education which must accompany the general use of bills drawn and accepted in dollars will take time and patience. One important function of the Reserve banks at the outset should be to standardize the development of this practice and put a premium upon that bill which conforms to sound business principles. Accommodation acceptance, where the bill does not represent the sale of commodities, should be discouraged, so that eventually a dollar acceptance will, in fact, represent the sale of a commodity, the proceeds of the ultimate sale of which will provide the funds to meet the bill at maturity.

Member Banks Responsible.

The second question has already been answered in part. The Reserve Board has, for the present, placed upon the management of each member bank the responsibility of determining and giving satisfactory assurance to the Reserve banks that paper offered by it for discount generally conforms to the intention of the Act. This is to be evidenced by the written statement of an officer of the member bank. Commencing with January 15th, however, the member banks will be required to affix, by stamped endorsement upon the note or by some other simple method, an indication that the note conforms to the requirements of the act and the definitions of the Reserve Board, and that credit information about the maker is available if called for. This again places upon the member bank, and not upon the Reserve Bank, the obligation to determine the eligibility of the paper. By authorizing this method the Federal Board has recognized the unwisdom of attempting revolutionary changes in business practice.

Financial Statements.

Assuming, however, that by later regulation the Reserve banks are themselves required to determine the eligibility of paper offered for rediscount, the third question arises, How shall the Reserve banks distinguish between that portion of the borrowings of a merchant which may have been applied to the building of factories, the purchase of machinery or to some other fixed investment, and that portion which has been invested in the purchase of goods for resale or which represents a sale of goods to a customer? Borrowed dollars are not earmarked in their journeys through the accounts of the borrower, and it therefore would necessitate an examination of the financial statements of borrowers to ascertain whether, in fact, borrowings are confined to an amount representing the business turn-over, or whether such borrowings, if representing fixed investments, may not result in a condition in the merchant's affairs which would make it impossible to discount the paper without violation of the provisions of the law.

By some means yet to be fully devised it must become possible to readily determine the eligible character and quality of paper of the various classes which may be offered to the Federal Reserve banks. I do not wish to suggest that the present system of mercantile

credits should be generally abandoned. The discount allowed for cash settlement is an important factor in our business system. But much of the trade of the country which is now conducted against book credits of 30, 60 or even 90 days, may properly be represented by mercantile paper if the inducement is attractive. Our vast domestic trade should not be disorganized or hampered by a sudden and radical departure from methods which are now satisfactory to merchants and which are approved by many bankers.

Single Name Paper.

The elimination from our money market of the single-name note may not be necessary or desirable, but, on the other hand, it is undoubtedly desirable that the paper in which our banks invest should more largely represent the purchase and sale of commodities and not permanent capital. The inducement to the making of double-name paper, representing, in fact, commercial transactions, will lie in a preferential rate, rather than in a regulation. Gradual changes in trade methods will aid in bringing this about. The best guide to a safe course will be experience. In the meantime, it seems to be the intention of the Reserve Board to facilitate adaptation to the new conditions, and to render the system effective at a time when its service may be of more value to American business men than at any time during the next generation. This system does, in fact, mean a gradual change in both banking and business methods. The complete accomplishment of its purpose will be brought about through the assistance, advice and patient co-operation of both the lender and the borrower, who by means of these banks will be brought together on a sounder basis than has heretofore prevailed.

Will Benefit Merchants.

Permit me to ask the members of this Association to give a careful study to the provisions of the law and to the regulations of the Reserve Board. Our new system may at first appear to have been devised for the service and protection of the banks. They own the stock, and the reserve deposits belong to them. The benefits of the system, however, will, in fact, be realized by the merchant who borrows money. It has already erased the word "panic" from our financial lexicon. Its purpose is to safeguard your credit and ultimately enlarge the field of your business enterprise.

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